First Trust
Monday Morning OUTLOOK
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Fundamentals, Not Headlines

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The S&P 500 dropped 2.5% on Friday while the yield on the 10-year Treasury note rose to 1.67%, the highest since June. You'll have to excuse us if we're unimpressed.

The increase in yields will probably continue, but not for the reason most investors think. Yes, the market's odds of the Federal Reserve raising rates in 2016 increased late last week, as did the odds of a rate hike this month, but the shift in the odds wasn't huge. Federal funds futures put the chances of at least one hike by December at 60% on Friday, versus 52% on Wednesday. Meanwhile, the odds of a hike in September rose to 30% from 22%. No great change.

Whether or not the Fed moves in September or December or both, long-term yields should move higher because nominal GDP growth – real GDP growth plus inflation – is up at a 3.3% annual rate in the past two years. It's even up at a 2.7% annual rate since late 2007, and that includes the drop in nominal GDP back during the panic of 2008. These figures suggest longer-term yields should be much higher than they've been.

Although some analysts say US yields can't rise much given low and even negative long-term interest rates in other countries, this ignores the influence of exchange rates on expected returns. At present, exchange rate forwards suggest investors think the yen and euro will appreciate versus the US dollar by about 2.2% and 1.8% per year, respectively, over the next ten years. In that environment, a 10-year Treasury offering 1.67% in dollars isn't necessarily a better investment than a 10-year Japanese note offering -0.02% or a German note at 0.01%. The US yield is obviously higher, but currency-adjusted returns are worse.

And despite equities falling sharply on Friday, we think the Fed hiking rates is a reason to buy stocks, not sell. The Fed is only going to raise rates if they think the economic recovery is sustainable and our model of equity prices suggests stocks would be undervalued even if the 10-year were 3.5%.

A recession would certainly be a reason to sell stocks, but we don't see one anywhere in sight. Monetary policy is loose and will still be loose even if the Fed raises rates twice this year, tax rates have room to drop but are relatively low by historical standards, and free trade is not yet in retreat. In addition, the housing recovery has much further to go and consumers' financial position is much improved from a decade ago.

Focusing on fundamentals rather than headlines lets investors cut through the weekly bombardment of economic and financial stories, the vast majority of which they should rightfully ignore. Those fundamentals tell us that Friday's market move was half right. In the weeks ahead, expect a rebound in stocks while yields move up some more.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-14 / 7:30 am	Import Prices – Aug	-0.1%	**-0.4%**		+0.1%
7:30 am	Export Prices – Aug	0.0%	**-0.2%**		+0.2%
9-15 / 7:30 pm	Initial Claims – Sep 10	265K	**261K**		259K
7:30 am	Retail Sales – Aug	-0.1%	**-0.2%**		0.0%
7:30 am	Retail Sales Ex-Auto – Aug	+0.2%	**+0.1%**		-0.3%
7:30 am	PPI – Aug	+0.1%	**0.0%**		-0.4%
7:30 am	"Core" PPI – Aug	+0.1%	**+0.1%**		-0.3%
7:30 am	Philly Fed Survey – Sep	1.0	**-3.0**		2.0
7:30 am	Empire State Mfg Survey – Sep	-1.0	**-1.5**		-4.2
8:15 am	Industrial Production – Aug	-0.2%	**-0.2%**		+0.7%
8:15 am	Capacity Utilization – Aug	75.7%	**75.7%**		75.9%
9:00 am	Business Inventories – Jul	+0.1%	**+0.1%**		+0.2%
9-16 / 7:30 pm	CPI – Aug	+0.1%	**+0.1%**		0.0%
7:30 pm	"Core" CPI – Aug	+0.2%	**+0.2%**		+0.1%
9:00 pm	U. Mich Consumer Sentiment- Sep	90.8	**90.3**		89.8